The Florida Senate

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Committee on Governmental Oversight and Productivity Senator Jack Latvala, Chairman

IMPLEMENTATION OF PENSION CHOICE FOR FLORIDA PUBLIC EMPLOYEES

SUMMARY

Following several years of advocacy and proposed legislation, the 2000 Florida Legislature permitted employees in the multi-employer Florida Retirement System (FRS) to choose between two different pension plan designs. Beginning in mid-2002 both current and new employees can select between the current defined benefit (DB), employer-guaranteed pension plan, or an employee-owned defined contribution (DC) plan. Public sector use of such alternate pension choices is relatively new although it is typical among large, private sector employers. The two-year development cycle for this undertaking is a collaborative effort of the state investment management agency, the State Board of Administration (SBA), a separate benefit payment entity, the Department of Management Services (DMS), and their retained consultants. This report discusses changes to the deployment and nature of public services, the salient features of the law, the tasks and time frames required before implementation, and the significant variables affecting the success of the undertaking.

BACKGROUND

The recently concluded decade was one marked by unprecedented economic growth and a willingness to challenge conventional methods of organization. No greater change occurred in government than in a reassessment of the previously unquestioned benevolence of the workplace for the public employee. Like never before, policymaking bodies across the country began legislating in terms of performance and productivity, meeting the competitive challenges posed by an increasingly mobile and educated workforce, and allocating funds on the basis of results. The State of Georgia even abandoned its civil service system.

These factors were influenced even more by the natural depletion of the public infrastructure resulting from the retirement of the children of World War II generation parents and a leveling of hiring due to technological change. In the five years ending in 1999, the State of Florida created only about 4,000 additional government positions. Yet, over the same period, the state budget grew by more than $6.6 billion. Appropriated funds per Full Time Equivalent employee increased from $230,000 in 1994 to $263,100 in 1999.

Increasingly, state legislatures are looking to the delivery of services indirectly through contract management rather than through enhancement of a labor-intensive public infrastructure. The imperative now is to buy, not to make. For Florida, the growth of contractually delivered public services is best exemplified in the *Special Category* appropriation, although other budget categories still contain purchased services. At a year 2000 level of more than $16 billion, it now contains more than 31% of the total state budget and is increasing in size greater than overall state revenue growth.[1]

The movement from a job- to a knowledge-based environment is also accompanied by different employment skill development. The recent transformation of public assistance from unquestioned entitlement to employment outreach and retraining reflected these federal and state priority shifts. Along with initiatives of the state personnel agency to develop workplace competencies other than employment longevity, it suggests a more concerted investment in emphasizing skill levels that keep pace with workplace changes and are not impervious to them.

Employee benefit programs mirror these changes as well. Flush with cash from a sustained economic recovery, many state retirement plans have reduced or

[1]The migration of directly provided government services to service contracting was discussed in *Procurement and Contracting Reform*, Senate Committee on Governmental Reform and Oversight, Interim Project Report 97-P-35, September 1997. In the three fiscal years between 1998 and 2001, total special category appropriations increased another 33% from $12 billion to $16 billion.

eliminated their accrued pension debts.[2] They are looking at emulating private sector plans to alter the unspoken contract between employer and employee from an expectation of longevity to one of performance, if only to reduce future taxpayer risk. Vendors delivering public services find themselves motivated more by time than career orientation: in a highly uncertain market they cannot afford to create pension systems stressing longevity.

The injection of notions of portability, choice, and personal investment responsibility are new phenomena for Florida government employees. Many of the principal workplace benefit programs are provided without cost (pension coverage and asset management, parking garages, life insurance, and dually employed spousal health insurance). Those requiring employee involvement reveal low participation (pre-tax benefits and deferred compensation). In a low wage environment employees gravitate to a benefit compensation ethic, all the more supported by a tradition of permanence and monopoly. The workplace benefit cost for State of Florida employees alone is 35% of payroll with vested leave liability exceeding $518 million. Including education-based employers, total unfunded leave liability exceeds $2 billion.[3] Benefit compensation exports to the employer the setting of all career and compensation goals including the financial deep pockets when things go awry.[4] The demographics of the FRS are also of note: most of the participants are women and low wage earners with the typical pensioner receiving a monthly benefit below $1,000 following a typical 21-year employment career.

The passage of Chapter 2000-169, Laws of Florida, set into motion the largest national public pension plan conversion. In so doing it committed each of the 800 employer-members of the FRS to the education of its respective employees on goal-oriented employment, where the variables of time and opportunity play very different roles. Initial estimates indicate about 31% of participants will choose a DC plan producing an asset conversion ranging from $8 billion to $18 billion. The statute gives existing and newly hired employees the opportunity to select a pension option based upon chosen career goals. Central to the choice process is information and education on the nature of the choices and how they fit with an employee's employment horizons. The expansion of this choice package extends to all FRS employees portable retirement planning previously available only in annuitized form to management and higher education faculty. Succeeding sections of this report discuss how this procurement is unfolding. It will look at the actions undertaken to date, the developing policy issues, and the challenges associated with decision making which affect employers and employees.

METHODOLOGY

This report discusses the implementation of this multifaceted and unprecedented procurement. It involves several state agencies, multiple retained consultants, and the elected trustees of the state pension plan. As the nominal lead agency, the State Board of Administration (SBA) has divided the project into four principal groupings, each with its own internal working group and assigned consultants. An *Investment Services Implementation Group* will review and recommend the suitability of various investment products for inclusion in the procurement. Investment selections will contain aggressive, moderate, conservative, and balanced investment classes using recognized products from vendors with established credentials who must adhere to performance benchmarks. The *Third Party Administrator Implementation Group* will review and recommend selection of a centralized financial services intermediary to account for the transfer of contributions from participant to provider and distribute periodic account statements. The *Education Services Provider Implementation Group* will formulate and select a third-party educator to inform all 600,000 active employee participants in the FRS about the scope of the choices before them in an objective, unconstrained manner. The *Asset Transition Work Group* will develop procedures for the transfer of participant plan assets from DB to DC through a retained broker. A separately constituted *Public Employee Optional Advisory Program (PEORP) Advisory Committee* was

[2] Few of the more than 400 local government DB pension plans overseen by the DMS ever had accrued pension liabilities.

[3] *Leave and Terminal Pay Provisions for Education Employees*, Interim Project Report 2000-34, Senate Committee on Education, September 1999; *Annual Workforce Report, Calendar Year 1999*, Department of Management Services.

[4] An adverse experience in 1995 with a prior third-party administrator for the state employee health insurance program required the replenishment of some $300 million for that self-insured program. This occurred through a combination of direct appropriations, benefit changes, and higher employee co-payments. The FRS is itself a product of adversity, having been formed in 1970 to stave off the insolvency of a prior plan funded with promises but not with cash.

also created by the legislation to provide a forum for employer and employee input on the selection criteria to be used in the procurement.

FINDINGS

Because this report comes only four months into a 24-month development period, most of the discussion will focus on process. From that standpoint the SBA has provided a timely and focused assembly of internal and external staff to brief the operational issues. On October 4, 2000 the SBA and the DMS commissioned the required letter requests for a favorable determination ruling from the Internal Revenue Service and have solicited public employer and employee input as required by s. 404 of the Internal Revenue Code. Draft *Requests for Information* (RFI) for the procurement of vendor services have been circulated for comment with a planned trustee selection date of January 23, 2001 for the TPA, April 17, 2001 for the education vendor, and by November 6, 2001 for the investment service providers. Additionally, a draft report on implementation of a revised disability insurance program for the PEORP program will be available from the Division's consultant by year's end. Along with the annual FRS actuarial valuation due by the end of 2000, the Legislature also will have to consider recalculation of available retirement fund surplus and the employer payroll contribution rates for succeeding years. The first actuarial estimates of the magnitude of these changes were made available on October 17, 2000. A draft retirement conformance bill for consideration by the 2001 Legislature to execute these changes is scheduled for development by SBA staff by January 15, 2001.

Two issues presented themselves as early obstacles but have been addressed with trustee concurrence. The first of these affected whether the procurement would proceed through the letting of competitive bids or through agency rule promulgation. Florida law provides specific criteria for development of administrative criteria that implement statute. Agency departure from these criteria can result in liability for incipient policy making that is accompanied by severe adverse financial consequences. At the same time, Florida law exempts contract letting from rule promulgation. To meet this potential obstacle, the SBA staff, upon the advice of multiple counsel, recommended that the announcement of the competitive procurement proceed through rulemaking with the actual procurement effected through a bid proposal. The effect would be to meet procedural challenges to the process, except for actions based upon the absence of clear statutory authority. The Governor, Treasurer and Comptroller approve all rules in their collegial capacities as Trustees of the FRS and agency head of the SBA. The initial rule development workshop was scheduled for October 13, 2000.

The other issue revolved around what has come to be popularly known as the "unbundled," or wholesale approach to investment product selection. "Bundling," or the aggregation of total investment, servicing, and education services by a single investment provider is a common investment organization method. The statute establishes the disaggregation of services as a preferred procurement method, however, with the belief that greater economies can be achieved for the participant with no compromise to investment result. The procurement will select the best funds for designated investment classes on the basis of performance and cost. As an institutional investor managing a $107 billion portfolio, the SBA is in a commanding position to negotiate the lowest fees and provide only those services that produce real value for the participant. The SBA staff believe there to be a possible spread of some 100 basis points between the two approaches based upon similarly situated vendors they have surveyed.[5] Upon the advice of the PEORP Committee and its own separate Investment Advisory Council, the SBA staff did agree to submit one bundled provider to the procurement that may offer up to nine fund choices. The trustees concurred in that revised policy statement and approved it at their September 26, 2000, meeting.

Policy issues remain which lie outside of the SBA's span of control. **First**, there may be tax consequences to the individual as well as the FRS for members choosing to switch back to the DB plan using the re-enrollment provisions of the law. For many employees it is plausible to assume the exercise of this option will be conditioned by an adverse market experience. Simply stated, they bought high and sold low and will have to indemnify the DB plan for the costs of re-enrollment. But for those transfers who bought low and sold high, can their gains be retained in their now dormant DC account or must they be relinquished? Whether this switchback provision should endure requires legislative resolution following review by the Internal Revenue Service. This issue is

[5] To illustrate the arithmetic involved, one basis point equals .0001. 100 basis points, or .01, applied against an estimated total asset transfer of $13 billion equals an additional expense of $130 million.

one of six questions propounded to the Internal Revenue Service for its review prior to implementation.

Second, for many employees the opportunity to receive a lump sum transfer to a successor pension plan will be its own enticement. They may be less well prepared for the diligence involved in personal investment management, thinking only of their recent acquisition of real equity and an estate in the process. These individuals may also find themselves choosing stable value products upon conversion only to find those yields significantly under-performing what could have been derived from the funded promises of the DB plan. Under-investment in early years may condition over-investment, or "yield chasing," in subsequent years to compensate for such conservative asset allocation. Deferred social consequences also can occur for employees who suffer adverse market experiences on the cusp of their retirement that deplete their accounts and condition unexpected reliance upon tax-supported systems. This underscores the importance of the education curriculum so that participants can exercise meaningful, informed, and independent control, and factor the values of risk and reward to their own circumstances.

Third, employees departing the DB plan will lose their eligibility for participation in the Deferred Retirement Option Program (DROP). With a fixed interest rate of 6.5% on the deferred monthly pension benefit, DROP account returns tend to reflect current certificate-of-deposit interest rates but lag historic equity market returns. Furthermore, unlike DB plan participants with statutory parameters around their nominal working careers [minimum of 6 years of service,[6] with normal retirement at the earlier attainment of age 62 or 30 years' service; age 55 or 25 years' service for public safety professions] DC participants must satisfy a one-year work period for vested rights. Unvested employer contributions for departing employees are forfeited if reemployment is not established within five years. Their work and retirement horizon is not otherwise constrained. They may work shortened careers, the same, or never cease working at all based upon their market experience. The employer's new promise to contribute substitutes for its prior promise to assure. The time-honored euphemisms of "thirty and out," "high five," or "five-year AFC" disappear from the lexicon: net asset value is all there is.

Fourth, significant members of the FRS are women and low wage earners, disproportionately concentrated in education and administrative/clerical occupations. They supplement household income and lag their male peers even when they are the principal wage source. Lower salaried workers are naturally risk averse with little discretionary spending ability. With longer life expectancies and a greater interest in security issues, women may be inclined to select conservatively valued funds in which long-term growth is not the primary consideration. As a result, their choices may under-perform overall markets.

Fifth, future benefit expansion within the DB plan complicates employee choice. Any subsequent legislative improvement to the FRS benefit structure may be perceived as a signal to remain in the DB plan. If performance bonuses are to be used with greater frequency, that itself may be a signal to switch plans since non-salary payments are excluded from benefit calculations in the DB plan but can be used as employee post-tax contributions to a DC account.[7]

Sixth, should the separate optional annuity programs now in existence for university and community college faculty, administrators, and senior public managers be consolidated into the PEORP program at some future date? These programs operate in a bundled fashion today. Such a consolidation would produce lower participant expenses although it would be accompanied by a loss of brand identification for those current provider companies and funds not included in the procurement. At the very least, maintenance of a separate Senior Management Class Optional Annuity program for only some 100 employees statewide does not appear to command the widespread attraction in fact that it does on paper. The same is true for the Administrative Support Special Risk Class of the DB plan: with only some 200 employees statewide in that class, and no new entrants into it, its consolidation within the Special Risk Class is worth consideration.

Seventh, the law permits noncommissionable participant account balance transfers to be accompanied by an electronic transfer of assets in securities or cash from the FRS to the succeeding investment provider. This method produces the least burden on the FRS Trust Fund, as it does not force the liquidation to cash of the proportionate share of assets and minimizes market turmoil. It does require the successor provider to reassemble these assets based upon *its* investment philosophy, not that of the SBA.

[6]The new vesting schedule is effective July 1, 2001.

[7]Federal law provides maximum limits to tax sheltered accounts when employee contributions are involved.

RECOMMENDATIONS

The SBA has weathered two early procedural issues to the initial implementation of the optional retirement program offering. Because the enabling statute contained within it a number of future benefit cost studies and expiring provisions in 2001, many of the issues discussed above may be readdressed in the forthcoming legislative session. Perhaps the most critical variable lies outside of the span of control of the State of Florida: whether the Internal Revenue Service's assessment of the plan and its final ruling on its qualified tax exempt status will be received sufficiently early for the 2001 Legislature to make the necessary changes. With multiple, free-standing DC plans already in existence for specific employee groups, now may be the time to consider a consolidation of these separate plans within the larger optional retirement procurement.

COMMITTEE(S) INVOLVED IN REPORT ***(Contact first committee for more information.)***
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MEMBER OVERSIGHT
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